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81-523

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

MOTION FOR LEAVE TO FILE

BRIEF AS AMICI CURIAE

The International Bankers Association in California and Akai Electric Co., Ltd. hereby respectfully move for leave to file their brief as amici curiae in the case, No. 81-523, which was previously filed in Chicago Bridge & Iron Company v. Caterpillar Tractor

No. 81-523

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal from the Supreme
Court of the State of California

MOTION OF

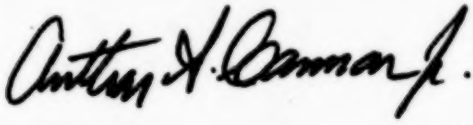
The International Bankers Association
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Akai Electric Co., Ltd.
an Amici Curiae
in Support of Appellant

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Co., Illinois Department of Revenue, et al., No. 81-349. The brief was filed in this latter case pursuant to consent of the parties and we request leave of the Court to consider this brief in the Court's review of the Container case.

Respectfully submitted,



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The International Bankers Association In California

Akai Electric Co., Ltd.

July 30, 1982.

No. 81-349

IN THE

Supreme Court of the United States

October Term, 1981

CHICAGO BRIDGE & IRON COMPANY,

Appellant,

vs.

CATERPILLAR TRACTOR CO., ILLINOIS DEPARTMENT OF REVENUE, *et al.*,

Appellees.

On Appeal from the Supreme Court of Illinois.

Brief for The International Bankers Association In California, Akai Electric Co., Ltd., as Amici Curiae in Support of Appellant.

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No. 81-349

IN THE

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CHICAGO BRIDGE & IRON COMPANY,

Appellant,

vs.

CATERPILLAR TRACTOR CO., ILLINOIS DEPARTMENT OF REVENUE, *et al.*,

Appellees.

Brief for The International Bankers Association in California, Akai Electric Co., Ltd., as Amici Curiae in Support of Appellant.

Statement of Interest.

This Brief is submitted with the written consent of all parties on file with the Clerk of this Court. The Amici fully support the position of Appellants in this case.

The Amici include a trade association of approximately 100 foreign banking institutions doing business in California and other States,[1] and a Japanese parent corporation having

[1]The International Bankers Association In California is a private, non-profit organization the members of which have their principal offices in more than twenty-four foreign countries and maintain California agencies or branches, and/or have wholly or partially owned domestic banks operating in California. The purpose of the Association is to further the development of the United States and California business economy and climate through considcration of issues affecting the banking community and reporting of the members' views to appropriate authorities.

United States subsidiaries operating in California and other States.

Particular members of the trade association may enjoy an advantage in California under the combined return-unitary business formula using world-wide calculations (hereinafter referred to as "world-wide apportionment") compared with a tax system based on separate accounting for income earned from arm's-length transactions in the jurisdiction (hereinafter referred to as "separate accounting"). Notwithstanding such advantage to certain members, the trade association and its members are concerned over the problems to foreign commerce presented by world-wide apportionment if used by some or all of the States. Their interest therefore, is not to support one system of taxation because of a perceived financial advantage. As a result of the foreign banking community's unique vantage point and perspective, the members and the association urgently wish to express their concern over the significantly adverse effect of world-wide apportionment upon the foreign relations of the United States and upon foreign commerce generaliy.

The Amici corporation is a foreign parent company whose California subsidiary is challenging the use of world-wide apportionment by the State of California. The Amici corporation has a different perspective than the Appellants with respect to the questions before this Court because it is a foreign-based multinational corporation.

Any decision of the Court in this case will affect foreign-based business entities having contact with the United States either directly or through an affiliated entity (such foreign-based business entities are hereinafter sometimes referred to as foreign multinational corporations, foreign companies or by other similar terms). The problems which foreign companies have experienced with world-wide apportionment are not presented by the facts of this case as vividly as if a foreign company were involved. The special concerns of the Foreign Commerce Clause cannot be understood as

fully as it should be from the vantage point of a domestic parent company. Finally, most treaties reserve to the contracting nation the sovereign right to tax their domestic entities as they shall determine. Taxing foreign companies, however, is a matter having significantly different dimensions.

Summary of Argument.

This case presents for decision the threshhold question whether the rationale of *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), extends to corporate income tax cases. Considerations of the Foreign Commerce Clause of the United States Constitution (Article I, Section 8, Clause 3), strongly support testing States' powers to impose income taxes on foreign source income of domestic or foreign taxpayers against the standards set forth in *Japan Line*.

If *Japan Line* applies, the question for decision is *whether* world-wide apportionment infringes upon the interest protected by the Foreign Commerce Clause. The two standards peculiar to foreign commerce which were adopted by *Japan Line*, and which are in addition to standards applicable to interstate commerce generally, are whether the state tax (1) impairs the power of the Federal government to regulate commerical relations with foreign countries thereby frustrating its ability to speak with one voice in such affairs, or (2) creates an unreasonable risk of duplicative taxation. World-wide apportionment as used by Illinois, California and a few other states apportions to the state taxing jurisdiction an amount of income subject to tax which bears no relation to the actual amount of net income earned within the jurisdiction based on separate accounting methods. Duplicative taxation occurs with respect to foreign source income to the extent to which the amount of apportioned income exceeds actual income determined under separate accounting methods. The reason is that income earned outside the United States by the unitary group of corporations has already been taxed fully, without apportionment, by the

country or countries in which earned through tax systems based on separate accounting methods. There is no way to avoid the risk of duplicative taxation under these circumstances, that is unless the taxing authorities of the states convince most foreign governments to change from the universally followed separate accounting approach to some type of world-wide apportionment formula.

The problems of duplicative taxation, distortion and inconsistencies resulting from imposition of world-wide apportionment by States, which might otherwise be tolerated under the Commerce Clause in the case of interstate commerce, become magnified to the extreme in the context of foreign commerce. Our trading partners have actually issued warnings to us that they are concerned about discrimination against foreign companies which is inherent in world-wide apportionment. The risk of retaliatory action cannot be controlled or resolved by the United States Congress or through our judicial system. The decision to retaliate rests with the foreign country. International disputes can only be resolved by the Federal government pursuing the goals of tax harmony, tax simplification and avoidance of duplicative taxation through networks of treaties and bilateral and multilateral trade agreements and negotiations, matters which are exclusively within the Federal government's responsibility and concern.

The States should not be limited in the exercise of their Constitutional rights to tax at their discretion income from business activity of foreign and domestic corporations earned within the United States, whether by separate accounting or by some type of unitary business method of apportionment consistent with the requirement of the Interstate Commerce Clause. Income earned outside the United States, however, should not be subjected to world-wide methods of apportionment but rather should be taxed by systems which do not create risks of duplicative taxation.

ARGUMENT.

I.

THE PRINCIPLES ESTABLISHED IN *JAPAN LINE* CONCERNING THE REQUIREMENTS OF THE FOREIGN COMMERCE CLAUSE ARE FULLY APPLICABLE TO A CASE INVOLVING A FRANCHISE OR CORPORATE INCOME TAX IMPOSED BY A STATE UTILIZING WORLD-WIDE APPORTIONMENT.

The Court below concluded that this Court's decision in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) was "obviously distinguishable" from the present case since no instrumentality or item of foreign commerce was involved and world-wide apportionment does not "affect Federal authority in governing foreign commerce".[2]

In *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425 (1980), this Court distinguished *Japan Line* on the four following grounds:[3] (a) *Japan Line* involved an ad valorem property tax assessed directly upon instrumentalities of foreign commerce; (b) the policies favoring allocation of property to a specific situs in property tax cases do not have applicability to income tax cases; (c) *Japan Line* was concerned with duplicative taxation at the international level whereas *Mobil Oil* presented questions of multiple taxation among the States; and (d) *Japan Line* presented actual duplicative taxation which was capable of remedy only by the Court's decision whereas the record in *Mobil Oil* set forth only a risk of such taxation.

Of the four grounds of distinction, only one appears relevant to cases involving world-wide apportionment, *i.e.*, that *Japan Line* was a property tax case involving an instrumentality of foreign commerce. As demonstrated in sub-

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[2]*Caterpillar Tractor Co. v. Daniel J. Lenckos*, 84 Ill.2d 102, 119, 417 N.E.2d 1343 (May 1980), which appears in Appendix C to Appellant's Jurisdictional Statement in its Appeal to this Court. *See also Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

[3]445 U.S. at 448.

sequent paragraphs, most cases involving world-wide apportionment present a record of actual duplicative taxation at the international level. Further, the specific allocation rules unique to property tax cases will not be relied upon by foreign multinationals in any challenge to world-wide apportionment.

The decision in *Mobil Oil* was narrowed solely to questions of multistate taxation and the issue of the States' power to tax previously taxed foreign source income was avoided.[4] This Court must now decide whether the principles enunciated in *Japan Line* concerning the special concerns of foreign commerce should be applied to duplicative taxation and other burdens for purposes of state corporate income taxes. The Amici strongly believe that the underpinnings of the Foreign Commerce Clause compel the principles enunciated in *Japan Line* to be so applied and that the *Japan Line* opinion should not be narrowed to be relevant only to cases involving instrumentalities of foreign commerce.

The Federal government was brought into being to assure the national and not parochial conduct of foreign affairs and uniform regulation of foreign commerce, matters of preeminent national concern. The States have no role in this area.

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[4] *Id.* at 447. The Court said:

> By admitting the power of the State of commercial domicile to tax foreign-source dividends *in full*, Mobil necessarily forgoes any contention that local duplication of foreign taxes is proscribed. Thus, the only inquiry of constitutional dimension is the familiar question whether taxation by apportionment at home produces significantly greater tax burdens than taxation by allocation. Once appellant's argument is placed in this perspective, the presence or absence of taxation abroad diminishes in importance.

The Court in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924), upheld the imposition in 1918 of a New York privilege tax on a British ale manufacturer which sold its product in New York. The case is clearly distinguishable from the present case because plaintiff failed to demonstrate that the New York method of apportionment had produced an unreasonable result through duplicative taxation or otherwise for purposes of the Due Process and Commerce Clauses

Article I, §8, clause 3 and the Supremacy Clause of the Constitution require the States to subordinate their laws, judicial decisions, and actions to the requirements of Federal uniformity in areas where such is essential. This Court has often stated that the United States must speak with one voice in matters of foreign affairs or commerce or it cannot credibly speak at all.[5] In distinguishing interstate commerce's tolerance for some duplicative taxation (citing *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978)), this Court underscored the special sensitivity of foreign commerce to the risk of duplicative taxation:[6]

> This case, by contrast, involves no mere mathematical imprecision in apportionment; it involves a situation where true apportionment does not exist and cannot be policed by this Court at all. Moorman, finally, concerned interstate commerce. This case concerns foreign commerce. Even a slight overlapping of tax—a problem that might be deemed de minimis in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned. (footnote omitted)

The vesting of such power in the national government not only forecloses a state from conducting its own foreign affairs but also requires a state to subordinate to the national interest its policies in areas where the local interests are usually primary. Thus, where a national interest approaches "the first magnitude," the President with the consent of the Senate may by treaty set aside local laws regulating game birds.[7] By the less formal means of "a protocol, a modus

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[5]*Japan Line, supra* note 2, at 449. *See Mobile County v. Kimball*, 102 U.S. 691, 697-98 (1881); *Inman Steamship Co. v. Tinker*, 94 U.S. 238, 245 (1877); *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 445-46 (1827); *The Federalist No. 22* (A. Hamilton); *The Federalist No. 42* (J. Madison).

[6]*Japan Line, supra* note 2, at 455-56.

[7]*Missouri v. Holland*, 252 U.S. 416, 435 (1920).

vivendi, a postal convention" or an exchange of correspondence with another nation, a state may be compelled to defer to international policy in a peculiarly local area such as that of property ownership or insurance regulation.[8] Even without the necessity of prior action by the national government, a state probate law becomes unenforceable when something more than an "indirect" or "incidental" effect on foreign relations is threatened, since in such a case "international controversies of the gravest moment could result" even though a wrong is "imagined" and not "real".[9] In *Zschernig v. Miller*, 389 U.S. 429 (1968), the Court said:[10]

> It seems inescapable that the type of probate law that Oregon enforces affects international relations in a persistent and subtle way. * * * The present Oregon law is not as gross an intrusion in the federal domain as those others might be. Yet, as we have said, it has a direct impact upon foreign relations and may well adversely affect the power of the central government to deal with those problems.

This court concluded in *Japan Line* that a state property tax on instrumentalities of foreign commerce must be voided if it either impairs the power of the Federal government to regulate commercial relations with foreign governments, *i.e.*, to speak with one voice in such matters, or creates a substantial risk of duplicative taxation.[11]

In matters of foreign commerce, an inquiry must be made whether disruptions or difficulties in relations with foreign countries or in trade will likely occur if a state tax is permitted to be imposed. It should make no difference whether it is a property, gross receipts, sales, franchise or corporate

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[8]*United States v. Belmont*, 301 U.S. 324, 330 (1937). *See also United States v. Pink*, 315 U.S. 203, 233-34 (1942).

[9]*Zschernig v. Miller*, 389 U.S. 429, 440 (1968).

[10]*Id.* at 440-41.

[11]*Japan Line*, *supra* note 2, at 451.

income tax.[12] The effect may be perceived more vividly in the case of instrumentalities of interstate commerce as in *Japan Line*. However, any disruption to foreign commerce or foreign relations, from whatever source or type of state action, requires the special sensitivity to the interests of the Foreign Commerce and Supremacy Clauses. There is no reason to presume that the need for national uniformity under the Foreign Commerce Clause would exist in the case of property taxes and not with respect to corporate income taxes. The potential for retaliation may, in fact, be greater in the case of corporate income taxes than with respect to property taxes due to the more significant amounts involved.

II.

FOREIGN COUNTRIES WITH WHOM WE TRADE OBJECT TO WORLD-WIDE APPORTIONMENT BECAUSE IT CREATES UNREASONABLE BURDENS OF COMPLIANCE, IS DISTORTIVE IN THE CONTEXT OF INTERNATIONAL TAX RELATIONS, AND MAY RESULT IN RETALIATION AGAINST THE UNITED STATES.

World-wide apportionment is perceived by the major foreign countries with whom we trade as unfair and discriminatory[13] to foreign trade and any investment which foreign companies may make in this country. Their outrage is directed to the principle of world-wide apportionment. The heart of the discrimination perceived by our trading partners is the difference in the methods used by foreign countries in taxing U.S. companies in foreign countries (*i.e.*, separate accounting) compared with the imposition of world-wide apportionment upon foreign citizens and domiciliary com-

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[12]*See, e.g., EVCO v. Jones*, 409 U.S. 91 (1972) (sales tax issue); *J. D. Adams Manufacturing Co. v. Storen*, 304 U.S. 307 (1938) (gross income tax).

[13]In the context of any given set of facts such discrimination may violate the Due Process Clause. Whenever the word "discrimination" is used herein, however, the context is the reaction of our foreign trading partners to what they perceive as discrimination and the effect this reaction has upon foreign commerce.

panies by the States, a difference which results in duplicative taxation.

In a prepared statement submitted to a Senate Finance Subcommittee in June, 1980, the Assistant Secretary of the Treasury for Tax Policy, Donald C. Lubick, stated that world-wide apportionment[14]

> has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the unitary systems differ from the arm's-length method which is used by the Federal Government and is generally accepted in international practice.

International protests were submitted in March, 1980 to the State Department by the nine countries comprising the European Economic Community.[15] Japan formally objected to world-wide apportionment in November, 1981, by including it as one of the most important of the fourteen points of trade dispute which Japan has with the United States.[16] In November and December of 1981, Japanese trade associations representing virtually every major business entity in Japan formally adopted resolutions of protest against world-wide apportionment used by the States.[17] In 1980,

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[14]*State Taxation of Interstate Commerce and World-wide Corporate Income: Hearings on S. 983 and S. 1688 Before the Senate Subcomm. on Taxation and Debt Management Generally, Senate Finance Comm.*, 96th Cong., 2d Sess. 44 (1980).

[15]The note is dated March 19, 1980, a copy of which is included in the Appendix hereto, at App. 1-3.

[16]*U.S. Will be Asked to End Non-Tariff Barriers*, JAPAN ECON. J., (Nov. 10, 1981) For the convenience of this Court, the entire article is included in the Appendix hereto, at App. 4-5.

[17]Copies of the resolutions are included in the Appendix hereto, at App. 6-12. The resolutions were adopted by the Keidanren (Federation of Economic Organizations, Japan), representing 916 corporations, associations and business organizations in Japan, and a committee of Japanese Corporations formed in the Kansai province of Japan, composed of 49 companies having U.S. interests. The action of the two groups indicates the breadth and depth of the Japanese sensitivity and opposition to the States' use of world-wide apportionment.

the United Kingdom, France and Canada submitted formal letters of protest to the State Department concerning the use of world-wide apportionment.[18]

We have been warned by our major foreign trading partners of their objections to the principles of world-wide apportionment, especially the unfairness of its use by a state when all countries use the separate accounting system in taxing U.S. companies. Their concern is with respect to the principles of the tax. As is the case with many members of the Amici trade association, world-wide apportionment sometimes produces less state income tax to a company than would otherwise be paid under the separate accounting method utilized in the arm's-length approach. It is not surprising that Caterpillar Company benefited by world-wide apportionment and that many U.S. companies do, including the Amici supporting Caterpillar before the Illinois Supreme Court. However, foreign companies generally find world-wide apportionment objectionable even if they benefit from it. To the best of our knowledge, no foreign company or country is filing an amicus brief before this Court in support of that tax system.

This Court recognized in *Japan Line* the adverse consequences which the entire nation might suffer if countries began to retaliate against the United States over the tax policies of one or more states.[19]

> If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American

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[18]A copy of the United Kingdom note is included in the Appendix hereto, at App. 13-16. The French note may be found at 1 CCH Tax Treaties, ¶ 2836A, at 2819-7D. The Canadian note may be found at 1 CCH Tax Treaties, ¶ 1317P, at 1249-31 to 1249-32.

[19]*Japan Line*, *supra* note 2, at 450-51.

> transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this nation from "speaking with one voice" in regulating foreign commerce. [footnote omitted]

The United States retaliated against France in the 1930's when it imposed a tax on dividends paid by U.S. parent corporations having French subsidiaries, which was apportioned on the basis of a U.S. company's French assets to its total world-wide assets.[20] Congress enacted a law following repeated warnings to France (which were not heeded as quickly as Congress wished) allowing the President of the United States to double the U.S. tax rate against citizens or corporations of a foreign country which imposed what would be viewed by the President as a discriminatory or extraterritorial tax on U.S. citizens or corporations.[21] The Government of France thereafter resolved the problem by ratifying a treaty with the United States to avoid such tax.[22]

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[20]*Hearings on the Tax Convention with the United Kingdom, the Republic of Korea, and the Republic of the Philippines. Before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 196-97 (1977) (Statement of John S. Nolan).

[21]Section 891, Internal Revenue Code of 1954, as amended, is the successor statute.

[22]A current example of pending retaliatory legislation by the United States against a foreign country is H.R. 5205 introduced in the House of Representatives in December, 1981. This bill is intended as the United States' response to a Canadian law which prohibits a Canadian business from deducting the cost of advertisements placed on United States border television or radio stations. H.R. 5205 provides that a United States business cannot deduct the cost of its advertisement on Canadian border television or radio stations. The proposed legislation is an example of retaliatory action using our tax laws to protest a foreign law which adversely affects United States interests. Foreign countries may use similar retaliatory legislation to object to world-wide apportionment.

It takes time before matters concerning a city, province, state or district tax are raised to the level of discourse, treaty negotiation or protest between countries. Discourse, treaty negotiations and formal protests have now occurred between the United States and foreign governments with respect to world-world apportionment. No state should upset international expectations by exercising its taxing authority in a manner which is clearly asymmetrical and distortive to a system of taxation which has been nurtured through decades of negotiations and is currently being followed by all countries in taxing foreign citizens and foreign domiciliary corporations.

1. Separate Accounting Is Used by All Countries to Tax Foreign Business Activities.

The context in which such objections are raised is that, in practice, all countries utilize separate accounting principles to tax business activities of citizens and corporations of foreign countries.[23] This system has been developed over the years through the negotiation of major disputes between and among nations, and in the development of the vast and complex system of treaties among nations. The practicalities

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[23]Attached in the Appendix hereto, at App. 17-19, is a copy of a letter from W. Michael Blumenthal, Secretary of the Treasury, to the California Franchise Tax Board, dated February 15, 1977, which states in part as follows:

> Though you state that unitary apportionment is "the most accurate and reasonable method yet devised" for assessing the income of one element in a multinational group, it is our experience, as well as that of most other countries, that the determination of income on the basis of an arm's-length standard is not only more accurate but also far less arbitrary. The arm's-length standard is the internationally accepted approach. Thus, in an international context, the use of another method by one jurisdiction will often lead to double taxation.

The separate accounting approach is the basis for the negotiation of our tax treaties with foreign countries. See the United States Treasury Department's Model Income Tax Treaty of May 17, 1977, 1 CCH Tax Treaties, ¶153, at 223.

of international trade and commerce require that the work toward tax harmony in this area be respected.

The protests raised by our trading partners about duplicative taxation and compliance burdens, therefore, constitute clear and unequivocal warning signals to the United States that the principle of world-wide apportionment is objectionable and will cause mischief in international affairs. The efforts of the Federal government to negotiate treaties restricting the right of states to impose world-wide apportionment indicates the Executive Branch's concern over its adverse impact upon our foreign commerce.[24]

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[24]Although the 1978 Senate vote in favor of ratifying the U.S./U.K. Tax Treaty was 49 yeas and 32 nays, the Treaty was not ratified with the restriction against a state's use of world-wide apportionment because the necessary two-thirds vote was not achieved. Opposition to the Treaty was led by Senator Church. The following statement was made by Senator Church during the course of the hearings on the Treaty and aptly summarizes the attitude of those Senators who voted in opposition to ratification.

> I think what the States are saying is that they ought to be allowed to make the decision of what system of taxation they should apply, and that if they are not allowed to make the decision, then that ought to be a judgment reached by the Congress as a whole, based upon national tax policy, and it ought not to be approached by the treaty route by singling out a certain country and starting there. The only handle the Congress has upon that is the ratification of the treaty by the Senate. The House of Representatives has traditionally had the prerogative under the Constitution of considering revenue measures first and determining tax policy initially, before it comes to the Senate.
>
> So, here we have a method that circumvents the traditional and constitutional arrangement, or the normal arrangement, for determining our tax policy. Whether the unitary system or the arm's length system is the best, I would not know. But, the fact that the States think they ought to have the right to decide which kind of tax to impose is the issue here.

Hearings on the Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, supra note 20, at 21. The same concern over protection of state's rights is prevalent today in consideration of various bills which would prohibit the use of world-wide apportionment. As a practical and political matter, therefore, neither the Executive nor Legislative Branches of government are likely to assess and balance the needs of the States to exercise their Constitutional powers to tax against the Constitutional interests of Federal uniformity in substantive matters of foreign commerce.

2. The Burden of Compliance With World-Wide Apportionment Is Unreasonable.

Our major trading partners view world-wide apportionment as unfair and discriminatory to foreign commerce for many reasons. The problem of compliance with a State's concept of world-wide apportionment is significantly greater to a foreign company than to a U.S. multinational company. World-wide records and financial information of foreign-based companies are not maintained in accordance with the standards required by a State's taxing system. U.S. multinational companies, on the other hand, routinely maintain books, records and financial information pursuant to accounting systems which are compatible with a state's regulations in most respects.

This Court should not permit a state's taxing power to be used in a manner which would coerce foreign multinational companies to maintain their books and records and those of their world-wide affiliate entities in substantial conformity with the accounting requirements of one or more of our States.

Foreign secrecy, national security and general non-disclosure laws can create an impossible dilemma for foreign multinational companies in disclosing world-wide financial information for state tax and other purposes. These laws sometimes provide that secret or confidential financial information of the business cannot be disclosed. If disclosed to any person (including a foreign government entity), serious civil and/or criminal penalties result.[25] However, the

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[25] *See, e.g.*, Switzerland's *Federal Law Relating to Banks and Savings Banks*, Section 14: *Responsibility and Penal Provisions, which provides in part:*

> *Article 41*. Persons entrusted with the management, superintendence, supervision and the control of the bank are liable to the bank as well as to each associate, shareholder or creditor for the damage caused by intentional or negligent violation of their duties.
>
> *Article 47*. 1. Whoever divulges a secret entrusted to him in his capacity as officer, employee, mandatory, liquidator or commissioner of a bank, as a representative of the Banking Commission, officer or employee of a recognized auditing company, or who has become aware of such a secret in this capacity, and whoever tries to induce others to violate professional secrecy, shall be punished by a prison term not to exceed six months or by a fine

failure to disclose this information in the United States may result in the officers being held in contempt of court. This dilemma is particularly acute in the international banking area where bank secrecy laws may be restrictive and may vary considerably from country to country.

Foreign companies engaged in national security or defense related activities may be prohibited by the laws of foreign countries from disclosing financial information regarding their business activities, including their property, payroll or sales. Disclosures by these companies, necessary for the computation of apportionable income, may therefore be prohibited by foreign law.

The practical consequences of applying world-wide apportionment is clearly evident in connection with the preparation of a combined return. To ensure the integrity of the figures upon which the return is made, offices of state governments may have to be established in foreign countries in order to review the books and records of multinational companies which have affiliated entities doing business in the United States. This is merely a logical extension of the fact today that offices of state taxing authorities are commonly maintained in cities of other States for such purposes.

At present there is no system whereby state authorities can verify the accuracy of world-wide net income, property values, payroll or sales of foreign multinational companies. In the absence of such a system, state taxing authorities commonly rely upon financial information contained in the annual reports of such foreign multinational companies which were prepared for purposes having nothing to do with tax reporting purposes. Taxation on this basis would be tantamount to the approval by this Court of taxing some U.S. companies based solely upon information carried in their published annual reports without adjustment for items of income, deduction and credits otherwise permitted under the taxing system.

World-wide apportionment may result in attempts by the various States imposing such a formula to verify the information submitted to it. It is submitted that the practical difficulties presented by such circumstances raise serious questions concerning the ability of the United States to carry out its goal of tax harmony with our major trading partners.

3. World-Wide Apportionment Discriminates Against Foreign Companies Attempting to Establish Business Activities in the United States.

Foreign investment in the United States is a recent phenomenon, principally occurring during the past fifteen years. It is not a coincidence, therefore, that the complaints of our major trading partners have arisen in only the last few years. This coincides with the first use of world-wide apportionment by the State of California to significant foreign investment beginning only since the late 1960's.

The foreign trading partners believe world-wide apportionment discriminates against foreign investment in the United States, especially in the case of new products which are intended to compete in established markets. Even if the operations of the foreign company in the United States result in significant losses during the early years, world-wide apportionment will result in a substantial tax if such company makes an overall profit from its world-wide business activities. The foreign company is taxed at home without apportionment on all its income and taxed again by the States. U.S. multinational companies of comparable size to a foreign company and having comparable business activities within and without the United States normally will incur a smaller overall tax liability than the foreign company because they are taxed in the foreign country on the basis of separate accounting with respect to their profits earned within such foreign country. U.S. companies further benefit from the right to deduct state taxes paid for federal income tax purposes, deductions of little use to a foreign company sustaining losses in the United States. Accordingly, U.S.

companies established in the U.S. market enjoy a competitive advantage over newly entering foreign companies which initially earn little or no profit. World-wide apportionment results in duplicative taxation usually without the benefit of any tax credit for taxes paid either to the state or the foreign government.

Actual double taxation can be demonstrated by the circumstances presented by one of the Amici. Akai America, Inc. is a wholly-owned subsidiary of Akai Electric Co., Ltd., one of the Amici in this brief. For the period 1972 through 1975, Akai America, Inc. (hereinafter "Akai") experienced a combined net operating loss for federal income tax purposes of over $8,000,000. The losses resulted principally from difficulties in establishing a presence in the United States market and the competitive conditions of the electronics industry generally. The California Franchise Tax Board has assessed a tax for such years in an aggregate amount in excess of $135,000 based upon world-wide apportionment. World-wide income of Akai's parent was fully taxed without apportionment abroad. This circumstance is not unusual and will generally occur whenever a foreign company wishes to establish business operations in the United States. Simply put, a penalty tax will be exacted by world-wide apportionment in most startup circumstances involving profitable foreign multinational companies.

There is no mechanism on the international level to adjust disputes among countries except through bilateral and multilateral negotiations. Our major foreign trading partners simply do not like world-wide apportionment as imposed by the States when it results in obvious duplicative taxation of profits which, in their view, are earned solely from their efforts in their own country and in countries outside the United States.

Justice Stevens summarized the general rule against taxing extraterritorial income in his dissent in *Mobil Oil* by

quoting from a legal scholar and adding his comments as follows:[26]

> "The basic proposition can be simply stated: At least as far as nondomiciliary corporations are concerned, a state may only tax income arising from sources within the state. Or, put differently, it cannot give its income tax extraterritorial effect."
>
> To put it still differently, if, in a particular case, use of an allocation formula has the effect of taxing income earned by an interstate entity outside the State, it could alternatively be said to have the effect of taxing the income earned by that entity inside the State at a rate higher than that used for a comparable, wholly intrastate business, a discrimination that violates the Commerce Clause.

4. Economic Factors Are Not Substantially Equal Among the Nations, a Circumstance Which Results in Unreasonable Distortion in World-Wide Apportionment.

Justice Holmes' opinion in *Fargo v. Hart*, 193 U.S. 490 (1904) quoted in the dissent filed in *Mobil Oil*,[27] is relevant to put in perspective the circumstances in which the use of a combined return of a unitary business is appropriate:[28]

> It is obvious, however, that this notion of organic unity may be made a means of unlawfully taxing the privilege [of carrying on commerce among the states], or property outside the state, under the name of enhanced value or good will, if it is not closely confined to its true meaning. So long as it fairly may be assumed that the different parts of a line are about equal in

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[26]*Mobil Oil*, *supra* note 3, at 451 (quoting Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX. L. REV. 171, 181 (1970)).

[27]*Id.* at 454.

[28]*Fargo v. Hart*, 193 U.S. 490, 499-500 (1904).

> value, a division by mileage is justifiable. But it is recognized in the cases that if, for instance, a railroad company had terminals in one state equal in value to all the rest of the line through another, the latter state could not make use of the unity of the road to equalize the value of every mile. That would be taxing property outside the state under a pretense. (citations omitted)

Foreign trading partners perceive world-wide apportionment as unfair and discriminatory because the factors used for apportionment are not sufficiently uniform from country to country as they are from state to state. The same dollar value of property, sales and payroll in the United States produces a significantly different return compared with the value of such factors in foreign countries, especially with respect to foreign countries on the western rim of the Pacific. As Assistant ecretary of the Treasury for Tax Policy, Donald C. Lubick, stated in his 1980 testimony before a subcommittee of the Senate Finance Committee:[29]

> [W]ith the United States paying higher wages than is true in many other foreign countries, you are going to have a distorting effect on the formula. You are going to generate the attraction of more income to the States, and that operates rather unfairly.

In addition, higher political, social and economic risks in foreign countries are taken by businesses only if the rewards of profitability are higher. World-wide apportionment disregards such differences and, in the process, overstates income apportioned to a particular state.

This distortive effect is not confined to the wages or payroll factor. Since foreign investment is a relatively recent phenomenon, foreign investment in the United States is measured by the value of today's dollars. In California, the property factor is determined on the basis of historical cost

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[29] ***Hearings on State Taxation of Interstate Commerce and Worldwide Corporate Income***, *supra* note 14, at 40.

and not current fair market value.[30] As a consequence, under world-wide apportionment new investment is accorded a greater allocation of profit than old investment. California-based multinational companies which establish markets and invest in current dollar values outside the State of California enjoy benefits from the reciprocal of this distortion and further advantage themselves compared with new foreign investment in the state.

Newly established plants, especially in high technology areas, require several years before the plants can be operated at the same levels of productivity and profitability as plants previously built in foreign countries. World-wide apportionment, therefore, causes the investing foreign company to pay a penalty for investing in the United States in businesses which they support and control. The same penalty may occur whenever a foreign company acquires the assets of an existing U.S. company by merger or otherwise. In many cases, targets for such acquisitions are companies which are operating marginally or have losses based upon standard federal income tax rules. Solely as a result of the acquisition, the acquired company's tax liabilities to a state under world-wide apportionment would increase significantly. Nothing would have changed in the operations of the company, its mangement or in its levels of productivity or profitability.

5. Changes in Currency Conversion Rates Artificially and Unreasonably Affect the Amount of Tax Liabilities Determined Pursuant to World-Wide Apportionment.

In many instances, whether a company is liable to pay tax to a state pursuant to world-wide apportionment (and the exact amount of such liability) will depend solely upon

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[30]CALIF. REV. & TAX. CODE § 26422 (West 1979) and 18 Cal. Admin. Code Reg. 25130(a) (May 29, 1971) issued thereunder.

the rise or fall of rates at which a currency of one country is converted into a currency of another. These factors depend wholly on circumstances outside the context of activity which the foreign multinational or its affiliate entities have and are pursuing in the United States. The stronger the dollar is against a foreign country's currency the more the three factors in the formula will allocate world-wide profit to the taxing state. Thus, with respect to each factor in the formula, currency depreciation and appreciation will significantly affect the numbers in the calculation. On the other hand, a stronger foreign currency will overstate world-wide net income before tax of a foreign based multinational. A company doing business in twenty or more countries may find the currency inflated in the country in which profits are highest yet find the dollar stronger compared with the currencies of countries which have most of the property, payroll and/or sales. The vagaries of the calculation, the problems of currency translation in general, and the artificiality connected with the method for determining the tax liability of operations in the United States are readily apparent and result in serious distortions in the case of foreign companies.

U.S. based multinational companies face similar problems in preparing returns or combined reports to States. The difference between U.S. and foreign companies, however, is not only in the degree to which foreign multinationals have interests and operations outside the United States but also with respect to the quality of the accounting and financial information at their disposal. A combination of these circumstances presents totally unique problems to foreign multinational companies when attempting to comply with world-wide apportionment imposed by a state.

6. Conclusion.

The principles enunciated in *Japan Line* concerning the Foreign Commerce Clause should be extended to the States' taxation of foreign source income if the risk of duplicative

taxation exists[31] or if the burdens on foreign commerce are significant. The use of world-wide apportionment by the States results in duplicative taxation of foreign and domestic companies and unreasonably burdens foreign commerce. This method of taxation clearly is encroaching upon the interest of the Federal government in preserving tax harmony, tax simplification and avoidance of duplicative taxation with our trading partners.

The States have no role or interest in this area. The only proper concern or interest which the States have is raising revenue pursuant to their Constitutional rights to levy taxes. Ample means are at the disposal of the States to further this interest. In deciding this case, we respectfully urge the Court to consider the effect its decision will have under the Foreign Commerce Clause upon foreign companies which are engaging in trade with, or investing in, the United States.

Respectfully submitted,

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LILLICK MCHOSE & CHARLES,
Attorneys for Amici Curiae
The International Bankers
Association In California
Akai Electric Co., Ltd.

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[31] *See* P. Hartman, *Federal Limitations on State and Local Taxation* (1981) in which the author stated his conclusion with respect to this issue as follow:

> [W]here income from a a multinational business is taxable in a foreign country as well as by the States, it is somewhat difficult to escape the conclusion that some aspects of the rationale of *Japan Line* would be present, unless *Japan Line* is confined to the actual levy of a property tax on instrumentalities of foreign commerce. *Id.* at 560.

APPENDIX.

Ambasciata D'Italia
Washington, D.C.

The Italian Embassy presents its compliments to the Department of State and, on behalf of the Nine EEC Governments, of which the Italian Government has now the presidency, it has the honor to forward the attached Note on the problems of the unitary method of taxation.

The Italian Embassy welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, D.C.
March 19, 1980
To the Department of State, Washington, D.C.

UNITARY TAXATION

1. Our Governments are concerned about the application to US subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other States.

2. The unitary basis makes no attempt to examine the profits generated by the subsidiary. It looks to the total profits of the worldwide operations of the group of which the subsidiary is a part, and claims a portion of those profits on the basis of the assumption that certain specified factors, such as the fixed asset values, turnover and payroll, affect the profits of the subsidiary in the same way and to the same extent as the profits of the group as a whole, irrespective of where the corporations of the group operate. This means that, whenever the group as a whole makes a profit the subsidiary will be taxed on a portion of this profit, even if the subsidiary is actually making a loss, or in the reverse situation, that the subsidiary may not be taxed if the group as a whole has made a loss, although the subsidiary is actually in a profit making position.

3. This method is incompatible with the principles accepted by all OECD member states and recommended to all states as a basis for the taxation of subsidiaries or permanent establishments of foreign enterprises. These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at "arm's length" between the subsidiary and related enterprises, i.e. that the transactions between the subsidiary and related corporations are on the same or on a comparable basis as transactions between wholly independent parties. This is intended to arrive at a fair measure of profit and rule out artificial pricing between members of the group for the sole purpose of minimizing tax liability.

4. Unless the same basic rules for calculating taxable profits are followed generally by the main trading nations it will be impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment.

5. The unitary tax basis can give rise to obviously inequable tax liabilities, and to a form of double taxation which often cannot be relieved, or can be relieved only if countries, which follow generally accepted practices, bear an unfair burden of relief.

6. Unitary taxation, because it requires worldwide reporting of the group's activities in the state where the subsidiary operates imposes very heavy compliance costs, in addition to the costs of compliance and reporting for non-US corporations in their "home countries".

7. The Federal Government uses the arms-length basis for its taxation of subsidiaries of foreign corporations.

8. The problem was addressed in the US/UK Double Taxation Treaty. Article 9 (4) of the Treaty, which was supported by the Administration, would have disallowed

the imposition of unitary taxes on subsidiaries of UK companies. When the Senate voted on the Treaty in 1978 the majority approved the Treaty with Article 9 (4) in its original form, although the necessary two-thirds majority was not achieved. Subsequently, the Senate approved the Treaty with the necessary two-thirds majority, but subject to the reservation that Article 9 (4) was not to apply for the purpose of state taxation. Article 9 (4) remained in the Treaty, but only for the purpose of national taxation.

9. There are currently four relevant bills in Congress. S983, S1688, HR 5093 and HR 5076, the last of which is scheduled for hearings on the 31st of March.

In the view of the strong arguments against unitary taxation, our Governments urge you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment.

Washington, D.C.
March 19, 1980

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November 10, 1981

HEADLINE: U.S. will be asked to end non-tariff barriers.

BODY: While the U.S. up to this time has been the one urging Japan to do away with so-called nontariff barriers, Japan now is going to submit a 14-point request asking the U.S. to do some removing on its own.

This was decided by the Japanese Government last week, and its "counter-demand" will list such as the following points as non-tariff barriers: 1) Administration of its trade system, such as its antidumping checkups; 2) Restriction in issuance of visas to Japanese company personnel; 3) the unitary tax system, such as practiced by the State of California.

So far, it has been the U.S. that has strongly done the criticizing, such as by citing Japan's import inspection system to be a non-tariff barrier.

The Japanese Government thus intends to submit its views to the U.S. during this month with the aim of obtaining a response from the U.S. side on the matter at the second meeting of the Japan-U.S. Trade Group, scheduled to be held in Tokyo from December 7 to 9.

The first topic it takes up is the anti-dumping investigation practice and the U.S. Government's administration of laws and regulations related to trading, such as tariff and trade laws.

This is because it is held that the U.S. Government's broad interpretation of laws has given cause to moves for ousting Japanese products on the alleged grounds of unfair competition.

One of the recent cases is considered to be the provisional judgment by the International Trade Commission in September that the contract won by Nippon Electric Co. for supplying Communications Satellite Corp. (COMSAT) with satellite communication equipment constituted a case of dumping.

The Japanese Government's feeling is that if the U.S. and its enterprises repeatedly raise suits against Japanese goods from an arbitrary interpretation of legalities, Japan's exports to the U.S. can be "frozen," commercial negotiations actually can be disrupted, and Japanese businesses may be called upon to submit such a voluminous amount of counterdata as to obstruct their daily work.

The 14-point request also considers the "Ship American" and "Buy American" policies as being typical non-tariff barriers as well that a problem exists, procedural or otherwise, as to the obligation of making a declaration on place of origin of a product, and manner of tariff classification.

As to the regulation specifying place of origin, the Government will point out that customs clearance often is withheld from such reasons as "lack of clarity" of the declaration, and some Japanese businesses even have given up exports to the U.S. of small items because of the difficulty of filling all of the data needed.

The Government also will cite as an example in the problem of tariff classification the case of polvethyene decorative hats. U.S. customs officials have been divided as to whether they should come under tariffs set for chemical products or for textile products.

Other "barriers" are regarded to be the unitary tax which provides for imposing an income tax on the earnings of the local enterprise together with the earnings of its parent firm.

Resolution for Urging an Abolition of the Unitary Tax Formula Based on World Wide Income.

by State Authorities of the United States of America

KEIDANREN (Federation of Economic Organizations, Japan)

December 8, 1981.

It is the common policy objective of nations to achieve their sound economic and social development through the maintenance and advancement of active international economic interchange. The activation of international investment and trade in recent years is a consequence of the efforts of governments and private business communities in many countries to remove impediments to economic exchange.

This trend is especially evident in Japanese-American economic relations. Their mutual understanding and cooperation have greatly advanced and have led to notable increases in direct investments by Japanese firms in the United States. The Japanese corporations which have established American subsidiaries have considerably benefitted the localities where they have found residence by way of increasing local employment, procurement of parts and components and investment funds. Further growth of direct Japanese investments in various regions of America is indispensable to the development of sound economic ties between Japan and the United States, a view commonly shared by government and business in both countries. It is important that continued efforts are steadfastly made to promote the two-way flow of direct investments.

Viewed in the light of these desirable developments, the extension of the unitary tax formula to foreign-owned businesses in the State of California and other states poses a serious impediment to direct Japanese investment in the U.S. It has become a major strain on business activities of

many Japanese corporations as well as their subsidiaries operating in the State of California. In the recent few years, a similar method of taxation began to be introduced in some other states, thereby causing serious concern among Japanese businesses which are planning to invest in the U.S.

There exists a general agreement among nations that the so-called the-arm's-length standard and independent party principles provide the most fair and adequate basis for apportioning the taxable income internationally. This is exemplified by the fact that "the Draft Double Taxation Convention on Income and Capital" by the Organization for Economic Cooperation and Development (OECD) is predicated on these principles. The global method of tax assessment, which includes foreign-source incomes as taxable income, cannot be accepted from the viewpoint of the OECD.

Extending the scope of application of the unitary tax formula to incomes generated outside the U.S. is a serious aberration from the internationally recognized norms of corporate income taxation. It is liable to result in double taxation and run into conflict with the widely accepted taxation principles as well. Such an unreasonable taxation policy is viewed with serious concern not only in Japan but also widely in the rest of the world.

As typified by the position of the National Association of Manufacturers, the American business community has also opposed for some time the application of the unitary tax formula to the off-shore incomes of U.S. enterprises and has demanded that it be abolished for the following reasons:

(1) The unitary tax formula distorts the internationally established principle, results in double taxation and hampers the active expansion by U.S. enterprises of their overseas operations;

(2) It is detrimental to the consistency of trade

policy and fairness of taxation for the United States, a federal entity, as provided under the U.S. Constitution.

It was pointed out in the Supplemental Report of the Japan-U.S. Economic Relations Group submitted in October 1981 to the Prime Minister of Japan and the President of the United States that "there are many sound reasons for terminating unitary taxation systems." The report further expressed hopes that "legislators on both the state and Federal level will take into consideration the deleterious effects (of such systems) on foreign investments." This opinion of the group is but one indication of the desire to see the abolition of the application of unitary tax formula to foreign source incomes commonly shared by those who desire the further growth of Japan-U.S. economic relations through increased investment flows.

From the considerations cited above and acting on the consensus of the Japanese business community, Keidanren strongly seeks abolition by the states concerned of the application of the unitary tax formula to foreign source incomes in the shared interest of sound development of Japan-U.S. economic relations. This organization thus transmits this resolution to the governments of Japan and the United States and to the United States Congress for appropriate disposition.

Resolution of the Council on Unitary Taxation.

We, the members of the Council on Unitary Taxation Issues[1] of Kansai Area, Japan, have met on this 10th day of December, 1981, and agreed that:

BACKGROUND OF THE UNITARY TAX PROBLEM

The so-called "Unitary Tax" (i.e., combined reporting with formula apportionment) levied on worldwide income by State Authorities of the United States, including the State of California, disregards existing national boundaries and different economic conditions and practices between Japan and the United States. Furthermore, such a method of taxation presumes unrealistically that a Japanese parent company and its subsidiary in the U.S. and other countries operate on the same profit level, in spite of different nationalities and business practices. Application of the Unitary

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[1]The Council on Unitary Taxation Issues of Kansai Area, Japan is comprised of 49 companies, all located in the Kansai area of Japan, who have formed an organization to consider and react to the imposition of California's Unitary Tax to their affiliated companies. The members of the Council are: Itoman and Co., Ltd., Iwatani Co., Ltd.; Osaka Transformer Co., Ltd.; Kanegafuchi Chemical Industry Co., Ltd.; Kawasaki Heavy Industries, Ltd.; Kansai Economic Federation; Kintetsu Department Store; Kyoto Chamber of Commerce and Industry; Kubota, Ltd.; Sanwa Bank, Ltd.; Sanyo Electric Co., Ltd.; Shimazu Corporation; Sharp Corporation; Shimpo Industrial Co., Ltd.; Shofu Dental Mfg. Company Ltd.; Sumitomo Metal Industries, Ltd.; Sumitomo Electric Industries, Ltd.; The Daiwa Bank, Ltd.; Takenaka Komuten Co., Ltd.; Omron Tateishi Electronics Company; Taiyo Co., Ltd.; Dainippon Screen Mfg. Co., Ltd.; Toyobo Co., Ltd.; The Tokai Bank Ltd.; Nissin Food Products Co., Ltd.; Nippon Sheet Glass Co., Ltd.; Nichicon Capacitor Ltd.; Hanwa Co., Ltd.; Hitachi Shipbuilding and Engineering Co., Ltd.; Horiba, Ltd.; Matsushita Electric Industrial Co., Ltd.; The Green Cross Corporation; Moon Bat Co., Ltd.; Wacoal Corp.; Wako Securities Co., Ltd.; Electronic Industries Association of Japan; Sanitory; Kanebo, Ltd.; Takeda Chemical Industries, Ltd.; Takashimaya Company, Ltd.; The Sumitomo Bank Ltd.; Sumitomo Mutual Life Insurance Company; The Taiyo Kobe Bank, Ltd.; Murata Manufacturing Company, Ltd.; Nippon Life Insurance Company; Kobe Steel, Ltd.; Daiwa House Industry Co., Ltd.; Teijin Limited; Koyo Seiko Co., Ltd.

Tax to Japanese parent companies is creating substantial distortion problems, unreasonable administrative burdens and significant misallocation of income.

SPECIFIC PROBLEMS WITH THE WORLDWIDE APPLICATION OF THE UNITARY TAX

We have discussed and indentified the following problems resulting from application of Unitary Tax on a worldwide basis:

1. By expanding its tax jurisdiction beyond state boundaries to Japan and other foreign countries, some States, including the State of California, which employ the Unitary Taxation method on a worldwide basis cause double taxation of income earned by Japanese parent corporations.

2. Without any reasonable grounds, States, including the State of California, which employ the Unitary Taxation method on a worldwide basis levy irrational taxes on income significantly different from that which Japanese subsidiaries in the States actually earned.

3. Japanese companies which have made direct and substantial investments in the U.S. to establish subsidiaries are burdened unnecessarily and excessively, in comparison with U.S. domestic companies, by the state imposed requirement of gathering, maintaining and supplying additional accounting

4. Application of the Unitary Tax on a worldwide basis poses a serious impediment to further Japanese investment in the United States, despite the fact that the United States is making a serious effort to promote such Japanese investment in the U.S.

RESOLUTION AND CONCERNS

Based on the problems listed above, we have agreed to oppose, in the most decisive manner, application of the Unitary Tax on a worldwide basis.

In addition, we are deeply concerned with the recent trend in the United States of additional states in the U.S. taking steps to apply the Unitary Taxation method on a worldwide basis to foreign companies.

Furthermore, we are concerned that nations of the developing countries may also begin to apply the Unitary Tax to foreign parent corporations. If the Unitary Taxation method prevails to such an extent, internationally accepted taxation principles will be disordered and, as a result, international trade and investment would be damaged.

RECOMMENDATIONS TO THE GOVERNMENTS OF JAPAN AND THE U.S.

With this resolution, we strongly urge the governments of Japan and the United States to take the following action:

1. Both governments should exert strong initiatives to lead all the states of the United States to adopt the so-called arm's-length principle for apportioning the taxable income of Japanese parent corporations and their U.S. subsidiaries. We believe that, as the U.S.-Japan tax treaty and the U.S. Federal tax law provide, the arm's-length standard is a fair and reasonable taxation method with respect to business transactions between Japan and the United States.

2. Both governments should take notice of the substantial impact which the Unitary Tax is having on bilateral trade and investment activities. The Japanese government should explicitly notify the U.S. government that, unless the unfairness imposed by the Unitary Tax is resolved, the Japanese government shall be concerned with a critical disruption of the bilateral investment relationship.

3. In close co-operation with Western European countries, which also object to the unfairness of the

Unitary Tax (applied on a worldwide basis), the Japanese government should consider raising the issue for discussion at a meeting of GATT.

CONCLUDING RECOMMENDATION TO JAPANESE BUSINESSES

Because of our grave concern with the inequitable nature of Unitary Taxation on our foreign investment activities, we, the members of the Committee on Unitary Taxation Issues in the Kansai area, earnestly appeal to the Japanese corporate decision makers to reconsider their foreign investment policies and make no further direct investment in the States of the United States which impose or are imposing a Unitary Tax on a worldwide basis.

United Kingdom

British Embassy
Washington, D.C. June 23, 1980

Hon. Harry F. Byrd. Jr.
Russell Senate Office Building
U.S. Senate, Washington, D.C.

My Dear Senator Byrd: In the context of the hearing of your Taxation Sub-Committee tomorrow on S. 983 and S. 1688, may I bring to your attention the views of my Government on the application of unitary taxation to the U.S. subsidiaries of British companies, set out in a note (copy attached) communicated to the Administration on March 25, 1980.

J. Anson, Minister, Economics

(Press release issued by the British Embassy Information Department)

U.K./U.S. DOUBLE TAXATION CONVENTION

The ratification by the Exchange of Instruments of the UK/US Double Taxation Convention took place in Washington on 25 March 1980.

The Convention enters into force on 25 April 1980.

Attached is a note of the details, together with an outline of the views which have been communicated by Her Majesty's Government to the US Administration at the time of ratification.

The Double Taxation Convention between the UK and the US which was signed in London on 31 December 1975, and the three supplementary Protocol which were signed in London on 26 August 1976, 31 March 1977 and 15 March 1979 respectively were ratified by the Exchange of Instruments in Washington on 25 March 1980.

The Convention as amended by the Protocols, will enter into force on 25 April 1980.

The following views have been conveyed by Her Majesty's Government to the US Administration.

It is a matter of regret to Her Majesty's Government that difficulties over one aspect of the Convention, although it is an important one, should have tended to obscure the achievement of the two Governments in reaching a fair and balanced agreement.

Among double taxation treaties, that between the British and United States Governments has a pre-eminent position. The economic and financial links between the two nations are so strong and the areas covered so diverse that apart from its intrinsic importance to the United Kingdom and the United States of America, the Convention attracts wide interest internationally and is a source of authority in its field.

Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9 (4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its original form would have prevented the United States Governemnt and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States. (*sic*) It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.

Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory. The Organisation for Economic Co-operation and Development has explored, encouraged and developed the "arm's-length" principle for regulating the taxation of multinational enterprises operating through subsidiary companies or branches. This principle requires that the subsidiary or

branch should be taxed only by reference to the profits which its own activities generate. Where these activities involve transactions with related enterprises and these transactions are not on the basis which would be made between wholly independent enterprises, the profits are to be adjusted for tax purposes by reference to the independent enterprise test, i.e., the "arm's-length" basis. This is intended to achieve a fair measure of the profit by cancelling the effect of any artificial pricing between related enterprises. The "arm's-length" approach has been internationally accepted and is a vital feature of double taxation conventions throughout the world.

The unitary basis with combined reporting is a quite different approach. It makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the world-wide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. The problems associated with this technique are many and have been well rehearsed. The tax consequences are unpredictable and arbitrary. The widely varying commercial and economic climates in different countries produce inequitable results. Under this system it can lead to a demand for tax by reference to group profits earned from unconnected activities in other parts of the world where they are already taxed, even although (*sic*) the local subsidiary is incurring substantial losses. On the unitary basis there is likely to be unrelieved and unrelievable double taxation. In addition the compliance costs are unacceptably high.

Apart from these inherent problems associated with the unitary tax basis, its incompatibility with the internationally accepted "arm's-length" basis would generate conflicts between the international investing and trading nations and disruption of international business if the precedent implicit in the Convention were to be followed by other countries. Unless common rules for determining the allocation of prof-

its between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment, for which the United States and the United Kingdom have striven together with their fellow members of the Organizations for Economic Co-operation and Development. It is the view of Her Majesty's Government that the unitary basis, which is not a practical international alternative to the "arm's-length" basis, could undo the important and patient international work that has been achieved in regulating international tax practices, and that every effort is required to discourage the use of the extension of that basis. It is to this end that the British and United States Governments have expressly prohibited its use for the purpose of the respective national tax systems under Article 9(4); and the issue will be an important aspect of the proposed annual review of the Convention.

Her Majesty's Government has recognized, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention, the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognized the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government for the reasons given above that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

February 15, 1977

Dear Mr. Huff:

Thank you for your letter of January 24, 1977 and the copy of your letter to Secretary Vance, concerning objections to paragraph 4 of Article 9 of the proposed income tax treaty with the United Kingdom.

I understand your concern over this provision, but I cannot agree, after careful review of the issue, that the provision should be withdrawn from Senate consideration. I support the objective of the provision and furthermore, I feel that the Senate should be given the opportunity to voice its opinion.

I am sure that the arguments in support of the provision are familiar to you, but I would like to summarize them briefly.

The scope of the provision is quite limited. It will restrict the ability of California to include foreign affiliated corporations of a corporation doing business in California, only when that corporation is controlled by a U.K. corporation (which is in turn controlled by British shareholders). I am aware, as you state in your letter, that this does provide limited preferential treatment for U.K. based multinational corporations. You must bear in mind, however, that a treaty is a negotiated document containing a number of concessions by both partners. In the pending treaty, the United Kingdom made very important concessions, particularly in the treatment of dividends paid to U.S. investors. We view the Article 9(4) provision as an appropriate quid-pro-quo for the concessions made by the United Kingdom.

The unitary apportionment system is inconsistent with accepted tax treaty policy which prohibits one country from

taxing the business profits of an enterprise of the other unless that enterprise is engaged in business through a permanent establishment in the first country. Under unitary apportionment, if the profit rate of the foreign member of a unitary group exceeds the profit rate of the member doing business in California, the effect is tantamount to taxing the profits of the foreign enterprise.

Though you state that unitary apportionment is "the most accurate and reasonable method yet devised" for assessing the income of one element in a multinational group, it is our experience, as well as that of most other countries, that the determination of income on the basis of an arm's-length standard is not only more accurate but also far less arbitrary. The arm's-length standard is the internationally accepted approach. Thus, in an international context, the use of another method by one jurisdiction will often lead to double taxation.

The unitary system imposes a substantial compliance burden on multinational corporations. Much of the information required for a combined report with respect to a foreign parent or foreign sister corporation may not be available to the taxpayer. Even where the information is available, the burden of reporting the accounts of many far-flung affiliates on a standardized basis can be great. We are aware of cases where this burden has discouraged foreign investment in the United States.

For all of these reasons, I repeat, the provisions of the proposed income tax treaty with the United Kingdom seem to me wholly appropriate and desirable.

Sincerely yours,

/s/ W. Michael Blumenthal
W. Michael Blumenthal

Mr. Martin Huff
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